DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

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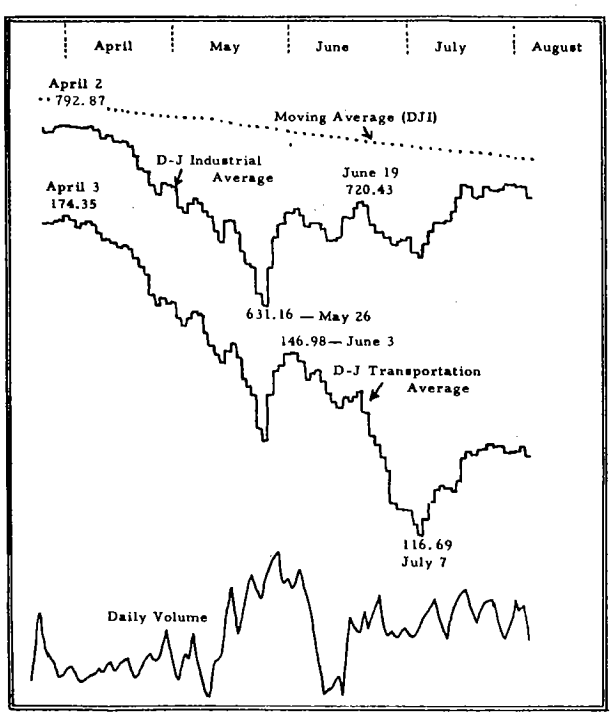
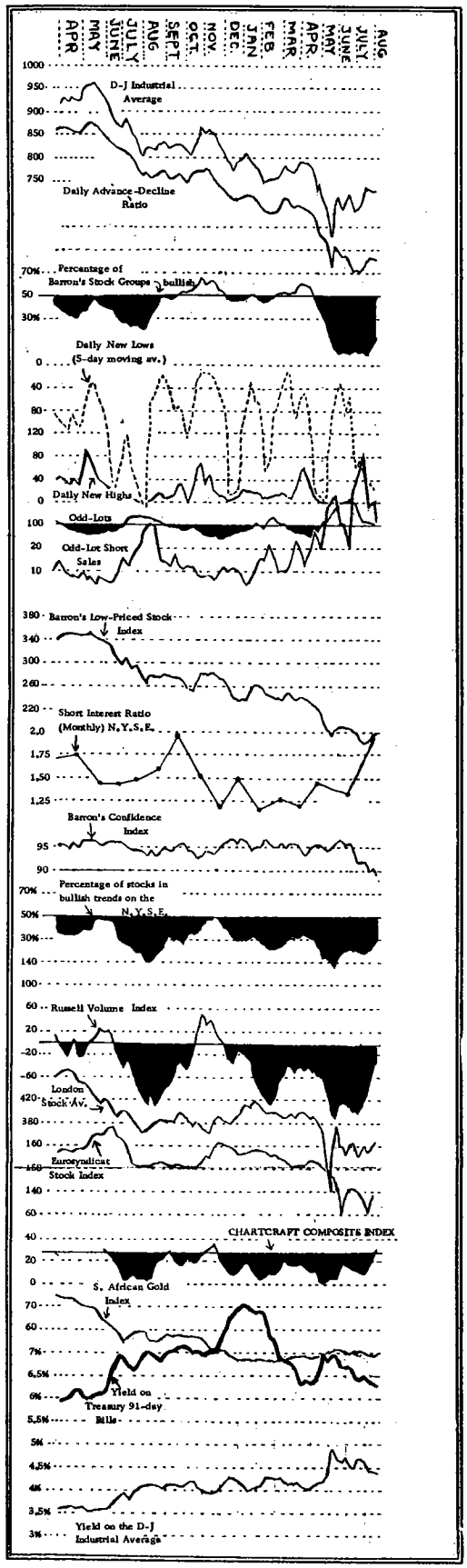
THE MARKET: If only the Administration could hold off reality until after elections. But the statistics just aren't politically oriented. Last week it was announced that wholesale prices rose in July at a .5% rate (or 6% annually), the fastest rate since January. One watches with something akin to fascination as the Administration airily "mouths" its way past one set of facts, then the next.

The staggering cost of inflation was dramatized in an interview with David Packard, Deputy Secretary of Defense (U.S. News and World Report). When asked how big a bite inflation takes out of the defense budget, Packard stated that the current defense budget is $71.8 billion, a drop of $6.9 billion from the $78.7 billion defense budget of 1968-69. But pay increases and inflationary factors have added $5.9 billion to Defense Dept. costs. Thus, all but $1 billion of the $6.9 billion reduction has been eaten up by inflation. "And in terms of purchasing power," said Packard, "the 1971 budget is really about $65.9 billion dollars —in terms of fiscal year 1969 dollars. Now this means in other words that, compared with the $78.7 billion dollars spent in fiscal 1969, there actually has been a nearly 13 billion-dollar reduction in the purchasing power of the Department's budget between fiscal 1969 and fiscal 1971."

All of which could be subject for rejoicing for those who believe that the U.S. is loading up with too many weapons of death. If the current trend continues, the U.S. will shortly be getting little or nothing in the way of military hardware in return for a measly defense budget of say $60 or $65 billion.

In all seriousness, however, I don't believe the current situation will be allowed to go on. With the Fed's recent re-pumping of the money supply,




D-J Industrial Average
Daily Advance-Decline Ratio
Percentage of Barron's Stock Groups bullish
Daily New Lows (5-day moving av.)
Daily New Highs
Odd-Lots
Odd-Lot Short Sales
Barron's Low-Priced Stock Index
Short Interest Ratio (Monthly) N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on the N.Y.S.E.
Russell Volume Index
London Stock Av.
Eurosyndicat Stock Index
CHARTCRAFT COMPOSITE INDEX
S. African Gold Index
Yield on Treasury 91-day Bills
Yield on the D-J Industrial Average

the whole Government "anti-inflation campaign" is seen to be a vast failure. As I view it, the Administration will attempt to squeek by with the current deception until after elections. Then, it will have to act or face the consequences. All this the market knows. The problem facing avid speculators is how to buy stocks, the vast majority of which are facing a profit squeeze, as an "inflation hedge". Veteran investors don't have this problem because they know that buying into a primary bear (even during an extended rally) is so risky that it is seldom worth the price in terms of man-hours of sleep lost. Through years of experience, they know the value of patiently standing aside as events connected with the primary bear market unfold. But the public, the speculators, the fund managers, they are all attuned to "action", and one senses that they are "straining at the bit" to buy that magic stock which will double over the next six months or so. To one who is standing momentarily at the ocean's edge, reality is made up of waves, and the waves roar in and they recede. But those who live by the shore (as I do here in La Jolla) think in terms of the tide coming in and the tide going out. If I walk to the beach and watch the waves for a few passing minutes, then (without prior knowledge) I have no inkling as to the direction of the ocean's greatest force, the main or primary tide. If I sink a stake at the water's edge, however, and return in a few hours it is immediately clear to me which way the tide is flowing. It is the same with those who study the market in terms of months rather than hours or days.

To turn to the current price action, it can be seen on the page 1 chart that the initial phase of the rally from the May 26 lows lifted the Transportation Average to a recovery high of 146.98. A few weeks later Industrials pushed to a recovery high (June 19) of 720.43. A decline followed into early-July, and during the decline Transports collapsed to a new bear market low of 116.69 (July 7). Industrials resisted downside-confirmation by a wide margin.

From the July 7 lows, a new rally mounted, and during late July Industrials recorded a succession of new recovery peaks. As of this writing, however, Transports have recouped just half the losses from the 146.98 recovery peak to the 116.69 July 7 low. Thus from the Dow Theory standpoint, nothing has been proved by the rise other than that a bear market never travels to its final lows in a straight line.

In the event of a continued refusal by Transports to better their 146.98 peak (regardless of new Industrial recovery highs), I would say that the rally is simply a deceptive push, under the guise of which smart investment money is continuing to distribute its wares. Once the technical recovery has exhausted itself, the primary bear forces will again assert themselves, and today's buyers will find themselves in the same position they found themselves in during the greater part of 1969 and early 1970. They will be holding stock certificates instead of cash in a market that is in the grip of the bear. It's the ideal prescription for going broke. Yet, if we think about it, someone has to buy shares during bear market rallies, and someone has to own each and every share during the course of a primary bear market. It's the bulls in every bear market (and by bull I mean anyone who owns a share) which makes the bear market a complex series of rallies and declines rather than a straight-line, one-day dive to some low figure. Only a tiny percentage of investors sell out at the top of a bull market and only a tiny percentage buy in at the bottom of a bear market. They are the people I am writing for, and they are the people who will be around a year, five years and ten years from now. The rest make up the vast majority in each generation who come in late during the bull trend and get out late during the bear trend. They, unfortunately, constitute the "fodder" upon which the market feeds. At the end of the full cycle they generally have little or nothing to show for their months and even years of waiting. They would have done far better tending to their own business, but the promise of something for nothing proved too much for them. One thing to remember is that Wall Street is actually the toughest place in the world in which to get something for nothing. Ask any professional who makes his living on Wall Street about that one.

TECHNICAL NOTES: The short interest ratio in the 30 Dow stocks rose to 1.19 in July (figures courtesy of Bill Gordon of New York). This is the first figure above 1.0 since August, 1969, but still a low and unimpressive figure.

We have now seen 48 consecutive days (since the May 26 Dow low) in which daily new lows have exceeded daily new highs. This is indicative of continuing distribution. Following the 1966 lows, new highs bettered new lows after 26 days; after the 1968 bottom new highs bettered new lows in only 5 days (figures courtesy of Larry Williams of William's Reports).

The 20 most-active stocks index recorded a high of plus 10 for the week ending July 24 (a very low reading for a 100-point Dow rally). On week ending July 31 the index backed off to plus 9. If this week produces more declines than advances on the 20 most-active list, the index will turn minus again (see Letter 467).

INTERNALLY: When the market becomes "difficult", it is always interesting to see what is happening internally. One of the best checks is the percentage of all N.Y.S.E. stocks, groups and the percentage of the 30 Dow Industrial stocks which are in bullish trends. I keep weekly charts on these statistics (from Chartcraft's tabulation) and these might be studied now (see last study in Letter 466).

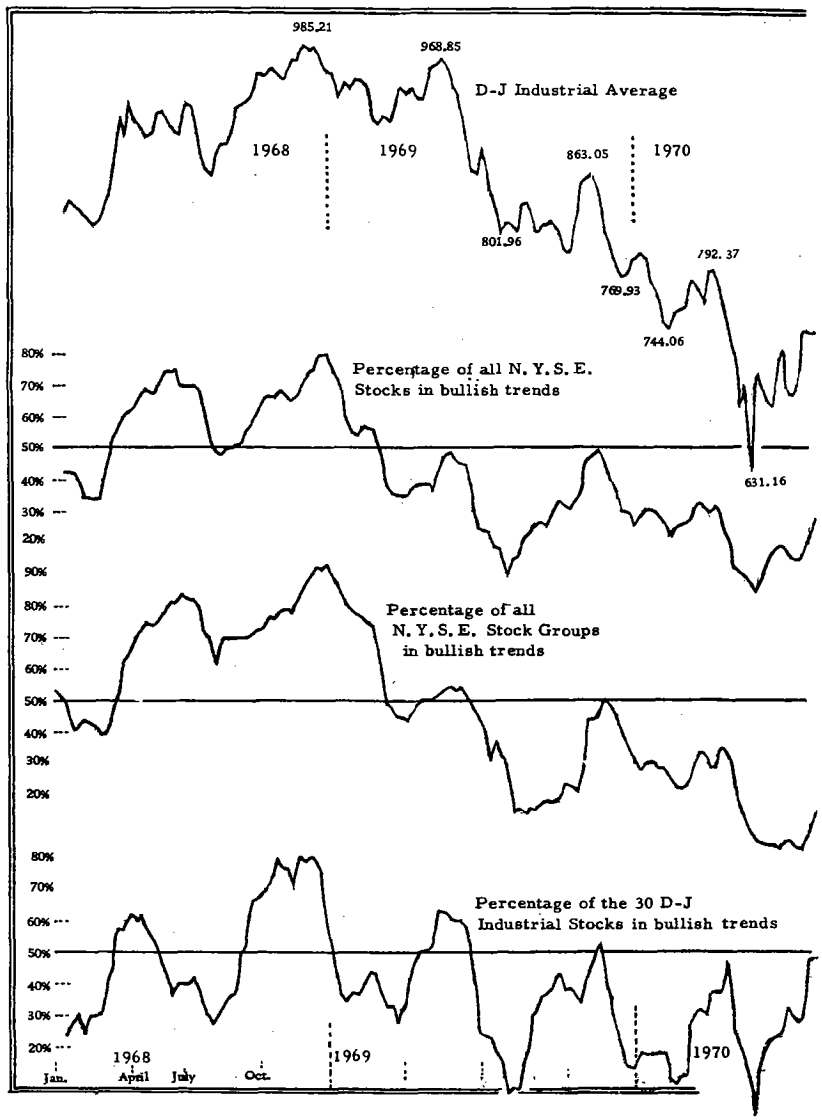
In terms of breadth of strength, with the Dow up over 100 points from its 631.16 bear market low, this has been (so far) a weak rally. For instance, note that on the 1969 rally which took the Dow from 801.96 to 863.05 the percentage of all stocks rose to

50%, the percentage of all groups rose to 50% and the Dow percentage rose to 52%. The rally fizzles out with the major percentage indicators unable to push decisively over the important 50% level.

Now examine the 1970 rally from 744.06 to 792.37. Here the all-stock percentage rose to 33%, the group percentage climbed rather half-heartedly to 35%, and the Dow bullish percentage rose to 48%. This was a less impressive performance than the 801 to 863 Dow-rally performance previously mentioned. Again the market fell back, with the Dow sinking to a bear market low of 631.16.

All of which takes us to the most recent rally. During the low week of May 27 the percentage of all stocks bullish was 5%, the group percentage fell to 8% and the Dow percentage dropped to zero. By the week of July 8 the group percentage had dropped to an extreme low of 2.4% bullish. But the rally centered in the Dow stocks was on.

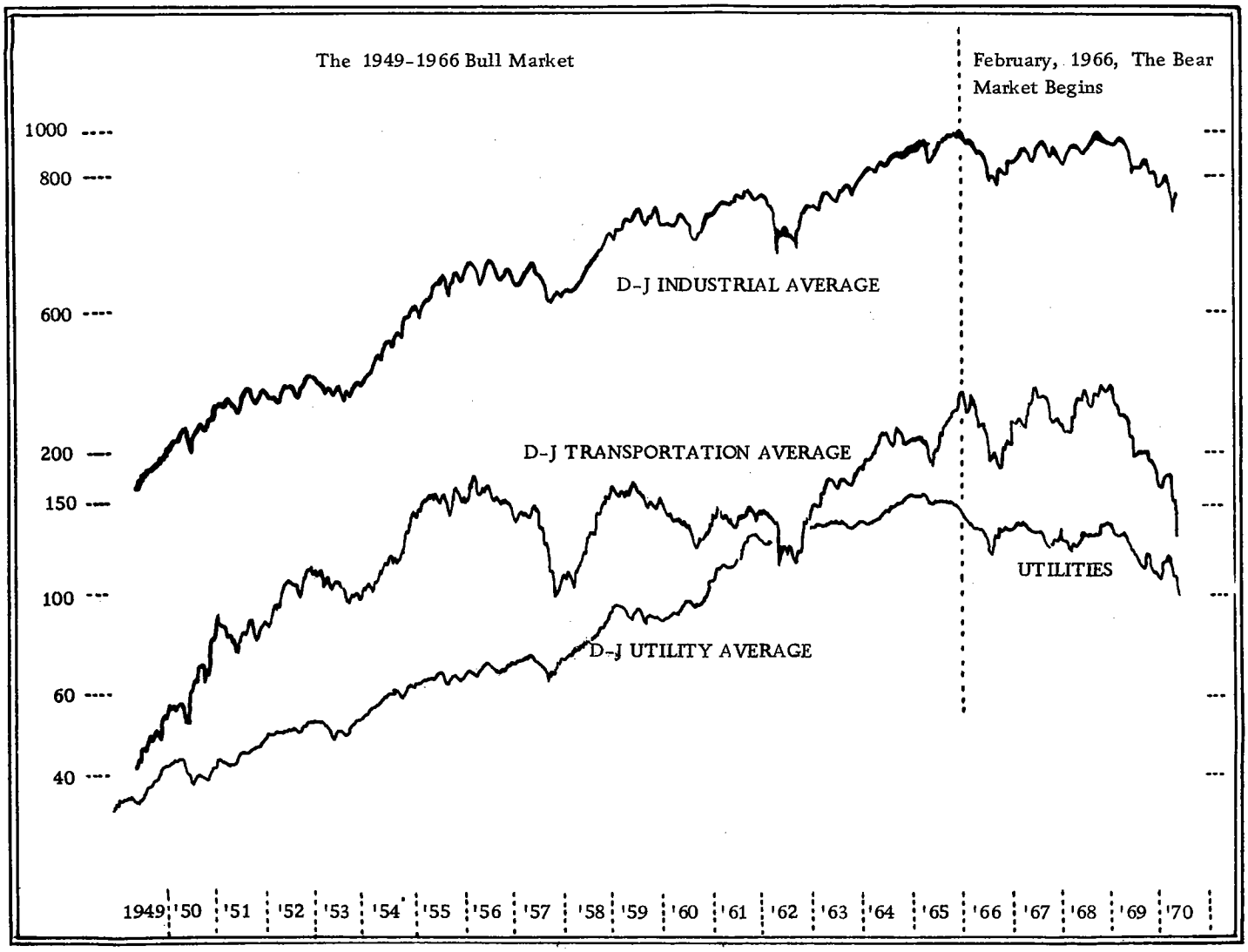
Checking last week's (week ending July 31) figures, we note that while the Dow had advanced to a July peak of 735, the all-stock percentage had risen to only 27% bullish. The group percentage was behaving very poorly, having rallied to only 15% bullish. The main strength of the rally was centered around the Dow stocks which had climbed to 47% bullish. On the whole, the performance of the three indicators was not impressive, and none of the indicators had climbed above the 50% level.



Finally, I want to say a word about the group bullish percentage. The sluggishness of the group indicator is very significant, since it requires fairly broad strength throughout the stocks in each group to turn each group bullish. I interpret the laggard performance of the group indicator to mean that only selective issues within various groups are bullish, and too few to turn many groups themselves bullish. For instance, if GM is strong, but Chrysler, Ford and American Motors are weak, the Dow Industrial Average may rally, but the auto group will probably not turn bullish. Therefore, the group bullish percentage, although seldom understood, is a very important check on the breadth of strength of any rally.

SINCE 1949.... I have drawn a chart (page 4) showing the path of the three D-J common stock Averages from 1949 to date. The price action is divided into two sections, the 1949 to 1966 primary bull market, and the primary bear market of 1966 to date. All the price action is drawn to semi-logarithmic or ratio scale, so that it shows percentage of advance or decline. For example, a rally from 100 to 200 constitutes a 100% advance. Such a rally on this chart will show as identical (in vertical distance) with a rally from 400 to 800, which also constitutes a 100% advance. Thus all movements on all three Averages can be correctly compared.

A study of the chart, among other things, will suggest that the bear market correction in Industrials has, so far, been sub-standard for a major bear market. The rise from 161 on the Dow in 1949 to 995 in 1966 tacked on 834 points. From the bull



market peak of 996 in 1966 to the bear market low (631) of 1970, the Dow gave up 364 points. Thus during the four years of the bear market, beginning with February, 1966, the Dow erased 43% of its entire 1949 to 1966 bull market rise. Now this may "feel" like a huge percentage correction, but the great majority of primary bear markets have wiped out 50% or more of the previous bull market gains. Thus, I term the bear market losses in Industrials (so far) as "sub-standard".

The Transports have faired worse than Industrials in the bear market so far. Starting at 41 in June, 1949, the Transports touched an early-1969 all-time high of 279. This constituted a total rise of 238 points. At the bear market low of 116, recorded in July, 1970, the Transports had erased 68% of all their gains since 1949. By any reckoning, the losses in Rails have been of major bear market proportions.

The Utilities, starting at 31 in 1948, rose to a high of 163 in late-1965. A rise of 132 points. At the June, 1970 lows, Utilities had fallen back to 96, their first major correction since 1949 (see chart). At 96 the Utility Average had lost 51% of all their gains since 1949. Although Utilities have fared much worse in previous bear markets (i.e., 1929-32 or 1932-37), the 1965-70 drop in Utilities must be considered of bear market proportions.

Looking at the whole picture so far, it appears to me that the Industrial Average should drop considerably lower before this bear market is over. Almost all of the major primary bear markets of the past 100 years have wiped out 50% or more of the preceding primary bull market gains. As a rule, the greater, more extended and more speculative the preceding bull market, the greater the chances of a drastic bear market. The preceding bull market of 1949-66 was the longest in history, it was one of the greatest percentage gainers, and it was one of the most, if not the most, speculative of all. Consequently, I would expect the bear market to correct considerably more than 43% of the previous bull market gains in terms of Dow points.

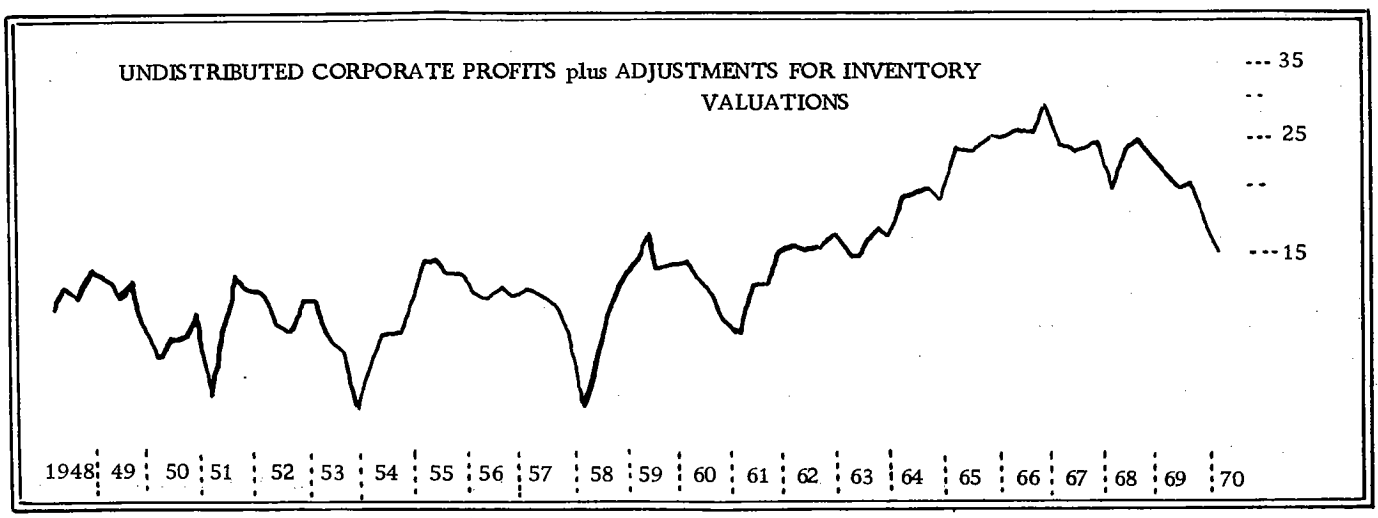
Furthermore, as documented repeatedly, the conditions at the May lows and since have not been suggestive of the termination of a major primary bear market. Bullishness still abounds, as seen in the violence of the rallies since May 26. The number of stock-

holders is now at a record high (see last Letter). Bonds still yield considerably more than average stock yields. The correction in low-priced stocks (as exemplified by Barron's Low Priced Stock Index) has been entirely sub-standard. Volume has been excessive, even at the bottom. No psychology of despair or deep depression ever overtook Wall Street at or near the bottom or since. Bullish rumors and propaganda have continually exerted a rallying influence on stocks (suggestive of heavy public participation). The great majority of Wall Street analysts and professionals became bullish a month or so after the bottom (many never turned bearish). All of these factors suggest that only a temporary or secondary bottom was seen at the May lows. Nothing so far suggests that the primary bear market which began in February, 1966, terminated in May, 1970.

WAGES AND PROFITS: In 1969 about 2.5 million workers received massive wage increases averaging 8.2%. This year, 1970, wage increases are averaging 8.6%, and 5 million workers are being affected, twice as many as in 1969. On top of this, another 5 million workers this year are to get deferred wage increases amounting to 5.7%. It's the biggest explosion in wage boosts since the Bureau of Labor Statistics started keeping records in 1913.

The result is going to be either (1) a continued or worse squeeze on corporate profits, (2) continued inflation in which corporations boost prices in order to absorb wage increases, or (3) some of both. If corporations raise prices to pass on the full brunt of continuing wage increases, inflation will turn so flagrant that it will become literally a national emergency. Therefore, it seems to me that a certain amount of these wage increases must and will come out of corporate profits.

There is another possible alternative, and it is the classical one. Classically, when the economy went into a squeeze or slump and unemployment rose, wages halted their upward spiral and even came down (as men looked for jobs instead of salary boosts). But with the rise of union power, this has become an almost unheard of phenomenon. The current galloping wage spiral has arrived during a time of tight money and extreme corporate illiquidity. This means to me that corporations must increase sales and raise prices, or suffer continued contraction in profits. The area where the squeeze on corporate cash and profits is showing up in is one that I pointed to in Letter 463, and that is reduced or omitted dividends.


UNDISTRIBUTED CORPORATE PROFITS plus ADJUSTMENTS FOR INVENTORY VALUATIONS
--- 35
--
--- 25
--
---15
1948 49 50 51 52 53 54 55 56 57 58 59 60 61 62 63 64 65 66 67 68 69 70

Another factor enters the labor-management picture in this time of tenuous liquidity. When a corporation is flush with cash (highly liquid) it can afford a strike, it can wait out the union and play it "tough". But with a huge debt load and high fixed expenses a strike becomes a different matter. Anything that slows down sales during a period of low liquidity can (because of fixed expenses) send a corporation to the wall. There is an old market adage which says, "Never sell on strike news." My feeling is that any prolonged strikes in the period ahead could be disastrous. For instance, how would Chrysler fair during a long auto strike? I would not suggest buying or holding the stock if a strike occurs.

I am including a very instructive chart from the Dept. of Commerce's Business Conditions Digest. This chart shows undistributed corporate profits plus changes in inventory valuations. In other words, this chart shows the real changing net worth of America's corporations in the form of retained profits. Note that where declines in this index became severe, such as during 1948-49, 1953 and 1957, those declines were associated with economic recessions. Since mid-1968 and continuing to the present, the decline in undistributed corporate profits has become drastic.

If this index continues down, it will mean that corporations are not retaining enough cash, and the result will be severe cost cutting, lay-offs, dividend cuts and omissions and a concentrated effort to increase productivity.

So far, then, the picture is one in which corporations are not able to hold onto profits because of any number of varied reasons. This is putting a strain on corporate net worth, and it cannot continue. I point to this because it is a factor which very few people are aware of or are talking about. It is the fruit of higher costs, higher interest rates, higher wages, and an unrealistic scale of dividend payouts. It adds up to a problem which must be solved unless the nation's corporations are to head into more trouble than has been seen at any time since World War II.

COMMON CURRENCY: In the current issue of the Morgan Guarantee Survey a major U.S. bank finally has taken cognizance of one of the really sensational events of the year. This was the meeting last December in the Hague by six countries of the European Economic Community, in which a European financial system was outlined. "Press reports of the conference were scanty and centered almost exclusively on the generally familiar issue of British entry into the Community," said the article.

What actually occurred was a commitment made by the six nations to a full economic and monetary union. "Americans should appreciate," said the piece, "though as yet many apparently do not, that this would have revolutionary consequences for the status of the dollar in the world monetary and financial system."

The union would limit the ability of the U.S. to run up its familiar balance-of-payments deficits. In the past twenty years, foreign nations have financed about $35 billion in U.S. deficits; it is obvious that they have absolutely no intention of allowing this to continue.

Perhaps the most important segment of the new plan has to do with a European Stabilization or Reserve Fund, and this would be preparatory to the creation of a European "Federal Reserve System" with its own currency. Thus, it is clear that what Europe wants is a system which will cut ties and dependency on the continuously inflating dollar. The rise of the dollar as the great international currency was predicated upon the rights of any nation to turn in its dollar for gold. That right is now in question, since Europeans now hold almost four times as many dollars as the U.S. owns in gold. Thus Europeans have been forced to finance our deficits while their Central Banks piled up with an ever-mounting mass of unwanted dollars. That situation is drawing to a close, and the "handwriting is on the wall."

The Morgan article ends with the statement, "The U.S. would, it is true, be deprived of financing facilities which have enabled it to avoid policy adjustments that otherwise would have been necessary. But this country's ability to defer adjustments has been a dubious blessing — one that has permitted a staggering pile-up of U.S. short-term debts to foreigners, rendering the country progressively more vulnerable to a cessation, or reversal, of unrequited inflows of short-term funds. To use a familiar phase, these facilities gave us in the past 'enough rope with which to hang ourselves'."

To translate, the European tolerance for U.S. balance-of-payments deficits has allowed this country to continue on its profligate ways. This road is rapidly and inexorably drawing to a close.

LATE NOTES: I just received reports from Irving Weiss (Money & Credit Reports) and Donald Storey (The Bank Credit Analyst). Both concur on one thing, and that is that corporate liquidity is worse now than it was during the last quarter of 1969. Storey shows an "all-corporations" chart and Weiss tabulated only the "billionaire manufacturers". So despite the talk of the Penn Central bankruptcy not setting off a tidal wave of similar troubles, the corporate liquidity picture is now worse than ever.

I am reproducing Weiss' latest breakdown of billionaire corporations, showing figures for the latest or first 1970 quarter, the last quarter of 1969 and the first quarter of 1965. Here he shows a first quarter drop in cash for each dollar of current liabilities, dollar of sales for each dollar of current liabilities, and dollars of current assets for each dollar of all debt.

Billionaire Manufacturers
(in Billions of $)

	1st Qtr. 1970	Last Qtr. 1969	First Qtr. 1965
Cash	12.1	12.	11.5
Current Liab.	62.2	57.4	19.8
¢ cash for each $ C/L	20¢	21¢	58¢
Qtly. Sales	64.1	65.6	29.7
Current Liab.	62.2	57.4	11.5
¢ sales for each $ C/L	$1.03	$1.14	$2.58
Current Assets	112.7	104.7	46.2
All Debt	119.7	110.3	34.6
$ C/A for each $ All Debt	94¢	95¢	$1.32